



Return to normal monetary policy – or is this time different?

After more than a decade of constant economic growth, increasing global trade, expansive monetary policy with low or negative interest rates and almost full employment, the Covid-19 pandemic led to the first upheavals, which were countered with generous fiscal stimuli. While supply has been constrained by supply chain issues, there has been increased consumer demand, particularly after lockdowns were lifted, which continues to this day. With the Ukraine war there was another supply shock, especially for fossil fuels, industrial metals, and certain staple foods. The central banks reacted late with interest rate increases when it became clear that inflation caused by supply-side constraints could no longer be presented as just a temporary phenomenon.

The US Federal Reserve (Fed) acted decisively and, starting in March 2022, increased the key interest rate (federal funds rate) in 10 steps from 0.0 - 0.25% to 5.0 - 5.25% today and slightly reduced the liquidity facilities to curb demand and core inflation (excluding energy / food) from 5.5% (as of the end of April 2023) towards the target level of 2.0%. The Fed accepts that the American economy is sliding towards a soft recession or at least a "slowcession" and triggered a minor banking crisis among Silicon Valley Bank and the American regional banks, which in many cases had failed to hedge against interest rate risks. With the interest rate increases, fixed income investments meant to be held to maturity have fallen significantly in value and some of these losses had to be realized as clients withdrew cash from their bank accounts and switched to larger banks or more attractive interest-bearing investments such as money market funds. Although the situation was brought under control with the expanded depositor insurance coverage and forced takeovers, these developments have led to more restrictive lending, which has the effect of an additional interest rate hike. We believe that there will be no further interest rate increases in

the US this year (also because the stability of the banking sector would be called into question again), but like JPMorgan and BlackRock we assume that interest rates will remain higher for longer and that, contrary to market expectations, interest rate cuts are not to be expected in 2023. However, this could change in the short term if an agreement on raising the debt ceiling is not reached in due time (according to Moody's Analytics, the deadline is 8 June 2023), and in the medium term there is a threat of a commercial real estate crisis in the US, as owners of office properties are facing rising vacancies and significantly higher refinancing costs.

The European Central Bank (ECB) initiated interest rate hikes even later than the Fed and increased the interest rate on the main refinancing operations in 7 steps starting in July 2022 from 0.0% to 3.75% today, in combination with a reduction of the balance sheet by more than 10%. However, inflation was pushed back less than in the US, on the one hand because the interest rate increases were less pronounced than economically indicated, probably out of consideration for the heavily indebted southern EU countries, on the other hand there are more second-round effects in the eurozone, such as substantial wage increases, causing the core inflation (5.6% as of the end of April 2023) to remain at a high level in the coming quarters, while real economic growth will be low at the same time. This means that further interest rate increases in the eurozone can be expected in the course of this year. At the same time, according to the bank lending survey, the ECB expects a further tightening of credit standards due to banks' higher risk perception and lower risk tolerance.

The Swiss National Bank (SNB) has implemented a total of 4 interest rate hikes since June 2022 and raised the key interest rate from -0.75% to 1.5%.

Within a year, the SNB also allowed the Swiss franc to appreciate by 7% against the euro and 11% against the dollar, which significantly eased imported inflation. With 2.6% at the end of April 2023, inflation was significantly lower than in other European countries, but still slightly above the announced price stability target of less than 2.0%. We assume that the SNB will raise the key interest rate again by 0.25% in June 2023. In our opinion, a further tightening of Swiss monetary policy will not be necessary because the higher interest rates and the forced takeover of Credit Suisse by UBS have resulted in more restrictive lending, especially for small and medium-sized companies that are not able to access the capital markets or the international banking market.

So, what's next? Leading economic indicators paint a mixed picture: on the one hand, consumer confidence in the OECD countries is at its lowest level since the start of the Covid-19 pandemic or the 2008 financial crisis, and yield curves are inverted in many parts of the world, which in the past was a reliable signal for a recession. On the other hand, consumption is still strong (albeit slightly declining as Covid-19 catch-up effects fade), supported by wage increases and low unemployment rates, and European industrial order backlogs are high. We believe this is a fragile situation and there are global and local factors that are clouding the outlook and, in some cases, are mutually reinforcing:

1. It is the declared goal of the central banks to reduce demand and consumption in order to combat inflation caused by supply-side issues. In the short term, however, it is a battle hard to win, as supply has been significantly reduced since the beginning of 2020 and will probably become even tighter as a result of corporate bankruptcies, and not least because the interest rate hikes will only take full effect after several months.
2. Inflation will be difficult to contain because inflation expectations are significantly above the target level of 2.0% in many countries, both in the short and medium term. As long as the labour market remains strong, workers will be able to push through wage increases

(particularly in countries with powerful unions), and many companies are passing higher production and input prices on to customers.

3. There are various medium- and long-term drivers of inflation: the increasing deglobalization with less international trade flows as a result of the Covid-19 pandemic and the Ukraine war (reshoring), as well as the shortage of skilled workers will increase production costs, and also extensive investments in digitization and sustainability (e.g., in energy production and security) must be reflected in product prices.
4. Short-term real interest rates in Europe are still well into negative territory, which has led to lenders expanding their margins in recent months to compensate for the difference between nominal and real interest rates. However, the agreed credit margins will continue to apply if real interest rates move into positive territory.
5. Loan default rates will increase substantially in the US and Europe over the next few months (not just for Covid-19 loans), with an expected peak in the first half of 2024. We will certainly not reach the default rates seen during the global financial crisis, but some suppliers will be hit by defaults of their customers and the issue of counterparty risk is coming back to the fore.

After more than ten years with low or even negative interest rates due to an excessively loose monetary policy, the changed interest rate environment actually means a return to normality, in which money has a price tag again. The process of adapting to the new situation will involve short-term friction, and a temporary upward or downward overshoot cannot be ruled out. However, we do not assume that it will be different this time and that we will return to zero interest rates in the short or medium term, but rather that the issues of inflation and higher interest rates will be with us for a few more years if there is not a pronounced and prolonged recession in the US and Europe.

The economic downturn will result in lower sales, depressed profitability, and lower operating cash flows for many companies, while higher interest rates and widening credit spreads will add pressure on highly leveraged companies. Small and medium-sized companies without access to the capital markets or to internationally syndicated loans are also hit harder than average by tightening credit standards of banks and in some cases may be cut off from the supply of bank loans altogether.

We recommend small and medium-sized companies with debt capital needs to act decisively, to adjust the business plan to the new situation and to secure the medium-term availability of debt capital on a committed basis, be it through banks or alternative lenders such as private debt funds, institutional investors, and family offices. In this way, companies can concentrate fully on their operative business in these turbulent times.

About Fincerta

Fincerta is an independent debt financing advisory boutique, which supports medium-sized companies in Switzerland and Europe in complex debt financing projects. With our comprehensive structuring and financing expertise, access to the relevant investors (banks, private debt funds, institutional investors, and family offices) and our disciplined project management, we achieve the best possible conditions for our customers.